(i) Compensatory pricing and auditable requirements: In Computer Inquiry II ("CI II"), the arm's length requirements required transfers of products to be at a compensatory price and transfers of money, personnel, resources or other assets to be recorded in auditable form. *NPRM,* para. 70. While the Commission eased the structural separation requirements of CI II in adopting CI III, the notion of compensatory price and auditability were carried over to CI III accounting safeguards. In essence, those requirements are reflected in existing Part 64 and Part 32 rules, and no additional rules are required to implement these protections for manufacturing or interLATA services affiliates. The affiliate transactions valuation rules that require the BOC to charge fully distributed costs ("FDC") for its services in the absence of tariff or prevailing price guarantee that the BOC will be fully compensated. For the transfer of assets, the BOC must charge the higher of net book cost or fair market value, again guaranteeing at least compensatory prices. The Commission's requirements for record-keeping and record retention also ensures auditable transactions.[29] Thus, the existing Part 64 and Part 32 rules are sufficient to ensure compliance with the compensatory pricing and auditable aspects of the arm's length requirement. *NPRM*, para. 73. The modifications that the Commission suggests are not necessary.

(ii) Writing and public availability: The requirements of §272(b)(5) that transactions be reduced to writing and available for public inspection are met by existing Part 64 requirements. *NPRM*, para. 74. The cost allocation manual ("CAM") that each BOC must file with the Commission satisfies both requirements: BOCs are required to describe all transactions

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[29] *Joint Cost Order,* paras. 242, 301; *Joint Cost Reconsideration Order*, para. 196; *see Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies,* CC Docket No. 86-182.

with their nonregulated affiliates in their CAMs; CAMs are publicly available. Competitors have had no difficulty scrutinizing the CAMs and raising objections about information therein. There is no need for additionally requiring Internet access to information about transactions.

Concerns about competitively sensitive or proprietary information can be minimized by limiting the level of detail required to be made publicly available. If detailed information must be made public, however, the standard confidentiality protection afforded by the Commission also should be available for affiliate transactions information as for other LEC submissions. For example, ARMIS reports that contain competitively sensitive or proprietary data have been granted confidential treatment and withheld from disclosure. The Commission is currently reviewing its procedures for protecting confidential information, which it acknowledges will be critically important as LECs become involved in greater numbers of competitive activities.[30]

(iii) Additional writing requirements: Because the 1996 Act requires that transactions between a BOC and its §272 affiliates must be in writing and publicly available, there is no need for the Commission to require additionally that requests from an affiliate for telephone exchange service or exchange access service be made publicly available. *NPRM*, para. 75. Service provided by a BOC to its affiliate would be a transaction, and thus, subject to §272(b)(5). The provision of any service must be described in the BOC's CAM. Moreover, because exchange and exchange access services are tariffed services, the terms of the transactions

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[30] *Examination of Current Policy Concerning the Treatment of Confidential Information Submitted to the Commission*, GC Docket No. 96-55, *Notice of Inquiry and Notice of Proposed Rulemaking*, FCC 96-109, Released March 25, 1996.

will be publicly available through the tariff.[31] Interconnection agreements, which must be filed with the state, will also be publicly available. Moreover, information on service installation intervals, reported in the ARMIS Service Quality Reports, are publicly available. To verify compliance in regard to service installation intervals, the Commission can compare service installation intervals for the BOC or its affiliates with the intervals reported in ARMIS. *NPRM*, para. 75.

(iv) Valuation rules: The Commission posits that current affiliate transactions valuation rules may not be consistent with the 1996 Act's requirement that transactions must be on an arm's length basis. As a remedy, it proposes several modifications: first, to require the identical valuation method for both assets and services, i.e., pricing based on a comparison of fair market value ("FMV") and fully distributed costs ("FDC"); second, to eliminate prevailing price as a valuation option. In addition, the Commission proposes to also permit valuation based on publicly filed agreements approved by a state regulator and to require a uniform rate of return of 11.25% for affiliate transactions. We strongly oppose the first two proposed changes.

a) The application of the asset transfer valuation rule to services should be rejected

The Commission proposes to require that affiliate transactions that do not involve tariffed assets or services be recorded at the higher of cost and estimated FMV when the carrier is the seller or transferor, and at the lower of cost and estimated FMV when the carrier is the buyer or transferee ("FDC/FMV comparison"). The applicable cost benchmarks would continue to be

[31] The Commission's affiliate transactions rules require an affiliate to pay tariffed price for tariffed services.

defined as net book costs for asset transfers and FDC for service transfers. *NPRM*, para. 78. Current rules only require the valuation of asset transfers based on the comparison between FDC and FMV. We oppose a requirement that would apply the same rule to transferred services.

The Commission claims that services should be subject to the FDC/FMV comparison to avoid rewarding a carrier's imprudent acts of buying an affiliate's services for more than FMV, and selling services to an affiliate for less than FMV even if the carrier recovers its fully distributed costs. The Commission opines that if increased costs are reflected in regulated rates, ratepayers may be harmed. This concern is unfounded for price cap carriers that have elected a nosharing option because price caps severs the link between costs and rates. While the FDC/FMV comparison should not be adopted for services, if the Commission does so, it should not be applied to a price cap carrier's affiliate transactions.

The Commission's related concern is that if a carrier sells service to its affiliate for FDC but for less than FMV, ratepayers and service providers not affiliated with the carrier may be harmed. *NPRM*, para. 77. The potential for harm has been eliminated by the nondiscrimination requirement of §272(e)(2) of the 1996 Act which prohibits a BOC from providing any facilities, services or information concerning its provision of exchange access to its §272 affiliate unless such facilities, services or information are made available to other providers of interLATA services in that market on the same terms and conditions.

There is no need to extend the application of the FDC/FMV comparison to transfers of services. In fact, there are distinct disadvantages to doing so.

(1) The Commission correctly rejected fair market valuation for services in an earlier proceeding

In the *Joint Cost* proceeding, the Commission understood the administrative issues in applying fair market valuation to affiliate service transactions. The difficulties led the Commission to reject the use of fair market valuation for services.[32]

> Several parties have argued that if a tariff or prevailing price list is unavailable as a measure of value, we should look to the value of similar services in the marketplace. We believe that such a valuation standard is fraught with the potential for abuse and would be difficult to monitor. In contrast, by requiring carriers and their affiliates to allocate costs pursuant to cost allocation standards, we can ensure that an auditable measure of the costs of the service is available.

The Commission was correct in 1987 and nothing since has occurred to justify a reversal of that decision. In fact, the strengthened safeguards adopted by the Commission since the initial Part 64 rules make monitoring the allocation of costs pursuant to the cost allocation standards even easier. More stringent annual independent audits, CAM uniformity requirements, and audit spreadsheet requirements provide additional means to substantiate compliance with cost allocation standards.

As the Commission recognized,[33] fully distributed cost is a better basis than fair market value for determining the cost of services between affiliates.[34] Fair market value estimates are inherently subjective. Services are usually not purchased based on cost alone, but

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[32] *Joint Cost Reconsideration Order,* para. 131.

[33] *Id.*

[34] Prevailing price is a better basis than FMV because it is based on actual BOC transactions with unaffiliated third parties, thus meeting arm's length and auditable requirements.

also on a number of noncost parameters such as quality and reliability. The complexities and subjective judgment required to compare nonidentical transactions can result in significant opposition and wrangling that will require additional Commission and carrier resources to resolve. For price cap carriers especially, this requirement has no redeeming benefit because the possibility of cross subsidy (and thus, the need for Part 64 rules) has been eliminated. Moreover, the cost of determining FMV and the attendant legal/regulatory efforts required to defend a BOC's decisions will result in decreased productivity and efficiency when competition demands greater productivity and efficiency.

Fully distributed costs are also more reliable than FMV because the rules to determine such costs are well established and carriers have had years of experience complying with them. Similarly, the Commission is experienced in assessing the BOCs' compliance with the current Part 64 rules. Requiring a comparison between FDC and FMV will add complexity and subjectivity to the Commission's audit process, and diminish the effectiveness of the current enforcement mechanism. Neither the Commission nor BOCs have an abundance of resources to deal with additional complexity.

(2) The proposed FDC/FMV comparison valuation will result in a subsidy from the nonregulated affiliate to ratepayers

For carriers that can affect revenues by classifying costs as regulated, valuation based on the FDC /FMV method will disrupt the balance between shareholder and ratepayer interests established by the Part 64 rules. If a service transaction is valued at FDC, the regulated entity is fully compensated for all costs it incurs to provide a service, including an allocation of overheads and a return on investment. If an affiliate is charged FMV because it exceeds FDC, the amount over FDC is a subsidy by the shareholder to the ratepayer because the affiliate is paying more than the regulated entity's full costs. The Commission properly disavowed this form of subsidy: "We are seeking to promote an equitable sharing of common costs; but we would not think it proper to attempt through cost allocation rules to arrange a subsidy for regulated activities."[35] Nothing in the 1996 Act suggests that Congress intended a subsidy from shareholders to ratepayers.

(3) Determining fair market value is costly

A requirement to determine the fair market value of services will create administrative burdens that are not justified by offsetting benefits. Pacific Bell has direct experience with providing market valuation for transactions with affiliates. The California Public Utilities Commission ("CPUC") requires Pacific Bell to determine market price for each nontariffed good or service with an annual aggregate billing to non-Bell affiliates that exceeds $100,000. Pacific Bell has historically hired an independent consultant to perform these studies. To date, the average cost of each study has been approximately $50,000. Pacific Bell's CAM currently lists over 100 different services provided to its nonregulated affiliates. If required, fair market valuation studies for 100 services would amount to $5 million. That cost is not justifiable, especially when the fully distributed cost of most of the services is less than $50,000 in annual billings.

Even if the Commission does not require formal market studies, the burden of undertaking informal determinations of FMV outweighs any potential benefit from a FDC/FMV

[35] *Joint Cost Order*, para. 109.

comparison. The requirement is burdensome because of the sheer number of services which would be subject to market value determination. The FDC/FMV comparison is less burdensome applied to assets because, as anticipated, there have been few asset transfers.[36] In contrast, a large number of services are transferred, and determining market value for all will require significant resources. As mentioned, Pacific Bell provides over 100 different services to affiliates, yet has only transferred regulated assets to affiliates on a few occasions since the inception of the Part 64 rules. Thus, requiring market valuation for every service transaction will be significantly more burdensome than a comparable requirement for asset transfers.

Moreover, FMV may not be determinable if an equivalent service is not available from third parties. For example, determining the FMV of joint marketing services would be extremely difficult.

(4) Fair market valuation should not apply to governance functions

Fair market valuation should not be required for governance functions provided to carriers by their regional holding companies. Sections 272(b) and (c) only regulate the relationship between the BOC and the required affiliate. They impose no restrictions on transactions between the holding company and the BOC or the holding company and the interLATA affiliate. Congress did not intend to impose an "arm's length" requirement on the provision of any services by the holding company to the interLATA affiliate, including governance functions. Thus, there is no need to change the Commission's existing FDC rule for valuing such transactions. Furthermore, the holding company, as the corporate parent, represents

[36] *Joint Cost Reconsideration Order,* para. 188.

the corporation as a whole and provides governance and other required corporate functions to its subsidiaries as part of its fiduciary duty to its shareholders to oversee its subsidiaries. Some corporate activities are required by law, such as tax filings in compliance with IRS requirements, and external financial reporting in compliance with SEC requirements. Costs associated with these functions are allocated to subsidiaries in compliance with SEC, state and federal regulatory requirements. Moreover, isolating and determining the FMV of corporate governance functions and activities will be difficult because a number of these functions are not available in the general marketplace.

(5) The Commission's rules should permit carriers flexibility in determining fair market value

If, however, the Commission adopts the FDC/FMV comparison for service transfers, carriers must be given flexibility in the means they use to determine FMV. We agree that requiring carriers to make good faith determinations of FMV is preferable to having the Commission specify methodologies that carriers must follow. *NPRM,* para. 83. Carriers should have the ability to choose reasonable and appropriate valuation methods. The Commission need not undertake the difficult and unnecessary task of establishing criteria for determining what constitutes a good faith estimate. *NPRM*, para. 84.

The Commission should also establish a threshold under which FMV studies would not be required. We suggest that the Commission require studies only for services with annual billings exceeding $250,000. This threshold will eliminate many services from the study requirement where the cost of a market study would probably exceed the value of the service being provided. Moreover, the Commission should only require a new study to be conducted every four years after the original study. During the interim period, studies would be annually updated by the Consumer Price Index.

In summary, we urge the Commission to reject the proposal to require a comparison between fully distributed costs and fair market value to value services transferred between a carrier and its affiliate. Services should continue to be valued at fully distributed costs in the absence of tariffed or prevailing price.

b) Eliminating prevailing price as an option unnecessarily reduces efficiency

The second modification to the affiliate transactions rules proposes to eliminate the prevailing price valuation method. The Commission tentatively concludes that the prevailing prices in affiliate transactions may not reflect fair market value primarily because of the different cost of transactions with affiliate and nonaffiliates. The Commission's conclusion appears to be based on the erroneous notion that sales between affiliates do not require extensive marketing efforts, and involve lower transactional costs than sales to nonaffiliates. *NPRM*, para. 80. We do not agree with the Commission's perspective. In our years of direct experience dealing with affiliates, we have not seen any reduction in marketing expenses as compared with dealing with third parties. In addition, systems and transaction costs incurred in complying with affiliate transaction rules would eliminate any putative savings. Moreover, if the proposed rule requiring service transactions with an affiliate to be valued at higher than fair market value (if FDC is higher than fair market value) is adopted, the BOC will have as much of a marketing job and commensurate transactional costs to sell its affiliate as it would any nonaffiliated prospective customer.

Some of the difficulties the Commission finds with the prevailing price valuation method are also problems with determining fair market value, and should not be a reason to eliminate the prevailing price option. For example, the Commission says that if the percentage of business done by the carrier or affiliate with third parties is small, there may not be enough participants in the market to ensure that the price equals the price the carrier and affiliate would have negotiated "on an arm's length basis." *NPRM*, para. 81. If this is the case, however, it will be equally difficult to determine fair market value. Similarly, the Commission says that it is difficult to determine the prevailing price of products or services because they are "technically complex and readily differentiated." *NPRM*, para. 81. If that is so, determining a fair market value for those products or services will be no easier.

Eliminating prevailing price as a valuation method merely reduces a carrier's options by removing a legitimate measure that could be useful in appropriate circumstances. Instead, the Commission should decide when a prevailing price would be appropriate. It should finish the task it started in the Affiliate Transactions Notice proceeding. As a general principle, an affiliate that has significant or substantial transactions with nonaffiliates should be allowed to charge the BOC its prevailing price for services.

Moreover, even if the Commission eliminates prevailing price as a valuation method, it should permit an affiliate's published price lists and transactions with unaffiliated parties to be reasonable and appropriate indicia of fair market value.

c) Valuation based on publicly filed agreements and SGAT are acceptable

We agree with the Commission that the affiliate transactions rules should be amended to permit rates appearing in publicly filed agreements submitted to a state commission and in statements of generally available terms ("SGAT") pursuant to §252(f) to be another acceptable valuation basis. *NPRM*, para. 86. Agreements and statements will be subject to review by state regulators similar to the review of tariffs and will have the same protection against unreasonable discrimination and cross subsidy.

d) The proposed return component is acceptable

We also agree with the Commission's proposal for a uniform rate of return to value affiliate transactions for carriers providing services subject to §272. *NPRM*, para. 88. The proposed rate of return of 11.25 percent is consistent with the return on investment that a BOC could anticipate if it were to use its investment to provide regulated services to nonaffiliates.

d. InterLATA Telecommunications Affiliates: Because Part 64 affiliate transactions rules only apply to nonregulated affiliates, the Commission inquires into the need to adapt its affiliate transactions rules or to adopt special valuation methodologies if both affiliates in a transaction are regulated. *NPRM*, paras. 89, 119. The Commission can order that any interLATA telecommunications services affiliate established under §272(a) be deemed to be nonregulated for Title II accounting purposes only. Then, the existing affiliate transactions rules will prevent cross subsidy. No adaptations to the affiliate transactions rules or special valuation methodologies are needed.

The Commission asks if it should require an affiliate that provides both regulated interLATA telecommunications services and nonregulated services to use Part 64 cost allocation rules to distinguish between regulated interLATA telecommunications services and nonregulated activities. *NPRM*, para. 90. There is no need to do so. First, the Commission should keep in mind the deregulatory intent of the 1996 Act which requires that it abstain from unnecessary regulation. Second, the Commission should support its often repeated maxim -- whenever possible, competition, not the Commission, should regulate the market. When the BOCs enter the interLATA market, it will be even more competitive than it is now. Thus, the affiliate will have no incentive to increase the costs of either its competitive interLATA telecommunications services or its competitive nonregulated services. Third, the administrative cost of applying Part 64 rules to an affiliate will load its competitive products with costs not incurred by competitors, raising the cost to the affiliate, and ultimately the price to consumers. The Commission must avoid regulations that discourage competition.

e. Joint Marketing: The Commission tentatively concludes that cost allocation and affiliate transactions rules, as modified, will apply to the joint marketing of interLATA and local exchange services if an affiliate may share marketing personnel with a BOC. *NPRM*, para. 91. Joint marketing occurs today between a BOC and its affiliates. Current safeguards have been effective, and continue to be sufficient to protect against cross subsidy and discrimination. There is no need for additional safeguards or the proposed modification which would apply the higher of FDC or FMV to services provided to an affiliate by the BOC. Given that the current affiliate transactions rules have worked successfully to ensure against cross subsidy, the current Part 64 rules should be permitted to continue without burdensome and unnecessary modification.

f. Audit Requirements: The 1996 Act requires a biennial Federal/State audit of a BOC's compliance with §272 requirements and implementing regulations.[37] The Commission proposes specific information that the independent auditor must include in its report to the FCC and relevant state commission which will be made available for public inspection. *NPRM*, para. 92. One requirement is a statement by the auditor that the carrier's cost allocation

[37] 47 U.S.C. §272(d).

methodologies conform to the Communications Act of 1934, as amended. This requirement exceeds what Congress intended as reflected by the statute, and would require a broader (and more costly) audit than required by the plain language of §272(d). The requirement should be eliminated.

Along with the §272(d) audit, BOCs are also required to undergo an annual CAM independent audit which examines the BOC's compliance with its CAM and Part 64 rules. The Commission should permit the biennial §272 audit to meet the annual CAM audit requirement to the extent the two overlap. This will eliminate the potential that Commission and carrier resources will be expended needlessly on redundant audits. The Commission should also make clear that the 1996 Act requires only the auditor's report to be made public, and not the audit workpapers. Although regulators would have unlimited access to audit workpapers, the Commission should state that workpapers, including material obtained from the examined entities, will be treated confidentially consistent with the Communications Act[38] and Commission policy for Part 64 audits.[39]

2. *Manufacturing by Certifying Entities*

The Commission tentatively concludes that application of the modified affiliate transactions rules to BOCs engaged in manufacturing pursuant to §273 would be sufficient to satisfy the provisions of the 1996 Act that authorize the Commission to prescribe rules and regulations to prevent cross subsidy. *NPRM*, para. 98. We agree except, as previously explained, the modification to require the higher (or lower, as appropriate) of FDC or FMV for

[38] 47 U.S.C. §220(f).

[39] *Joint Cost Order*, para. 283.

services is unnecessary, and will disadvantage affiliates engaged in competitive activities. For that reason, the modifications should not be adopted.

3. *Electronic Publishing Services*

The Commission asks if there is a distinction between a "separated affiliate" under §274 and a "separate affiliate" under §272, and if this distinction requires or permits different accounting treatment for affiliate transactions pursuant to §§272 and 274. *NPRM,* para. 105. No significant difference between a separated and separate affiliate would require different accounting treatment. The 1996 Act does not distinguish among these entities (including joint ventures) in directing that the Commission develop regulations to prevent improper cross subsidies. Thus, the Commission should apply the existing affiliate transactions rules to transactions between a BOC and its separate affiliate, separated affiliate, or joint venture.

The 1996 Act requires the separated affiliate or joint venture and its BOC affiliate to each undertake an annual compliance review performed by an independent entity to determine compliance with §274.[40] The statute further requires that the examined entity file a report of any exceptions and corrective action with the Commission. *NPRM,* para. 106.

The statutory language in §274 clearly demonstrates Congress's intent that the compliance review of electronic publishing significantly differ from the biennial audit required for §272 affiliates. Yet, the Commission proposes to require the same specific information from the independent reviewer for the compliance review as it requires for the §274 audit. As with the §272 audit report, the §274 compliance report must include a statement as to whether the carrier's accounting and affiliate transactions methodologies conform to the Communications

[40] The §274 compliance review is to be distinguished from the §272 biennial audit.

Act of 1934 and the Commission's rules. That proposed requirement goes beyond what Congress intended. In effect, the Commission requires a review to cover more than the rules and regulations implementing §274. Moreover, it would be difficult for the auditor reviewing the books of the separated affiliate or joint venture to make any statements about the carrier's compliance with the requirements of the Communications Act. The Commission should limit the scope of the review to compliance with the Part 64 rules applicable to §274 affiliates as Congress clearly intended.

To the extent that the §274 compliance review overlaps areas that would be examined as part of the annual CAM audit, the compliance review should also satisfy the CAM audit requirement. The BOC should not have to fund two reviews of the same activities for the same period.

Finally, given the competitive nature of electronic publishing activities, the report of exceptions and corrective actions should exclude any competitively sensitive information. To the extent confidential or proprietary information is included, the Commission's standard protection for proprietary or confidential information should be available to protect information obtained in the course of the review. *NPRM*, para. 107.

The requirement for electronic publishing affiliates to provide reports substantially equivalent to the SEC's Form 10-K, as required by §274(f), can be satisfied by requiring the affiliate to provide financial statements which conform to SEC 10-K guidelines included in Regulation S-X. These include a balance sheet, income statement, and statement of cash flows. These items will meet the requirements of §274(f).

Additional reporting, such as descriptions of the business, management discussion and analysis, and footnotes should not be required. These additional requirements (for example, pension disclosures) are of a corporate nature, and make little sense within the context of a stand-alone, wholly-owned subsidiary. Also, such information is already disclosed in the affiliate's parent company's 10-K filings. Material items which affect an electronic publishing subsidiary would be disclosed on the parent company's 10-K. Moreover, the Foreign Corrupt Practices Act requires public, domestic companies to maintain books, records, and accounts in reasonable detail which accurately and fairly reflect transactions. Preparing separate reports for a subsidiary would be costly and would not have additional informational value.

The requirement of §274(b)(1) that the separated affiliate or joint venture maintain books, records and accounts, and prepare separate financial statements is self-effectuating. No further accounting, bookkeeping or record keeping requirements need be developed by the Commission. Nor are additional rules needed to implement the requirement that entities carry out transactions "in a manner consistent with such independence." *NPRM*, para. 110. Section 274(b) extensively spells out the arm's length requirements for transactions. Nothing more is needed. Similarly, there is no need for additional rules to implement the requirement that transactions be carried out in a manner that is auditable in accordance with generally accepted auditing standards. *NPRM*, para. 111. For the past 8 years, auditors have reviewed transactions between BOCs and their affiliates without a rule requiring auditable standards. Nothing about transactions between a BOC and its electronic publishing separated affiliate or joint venture suggests that requiring auditing standards are necessary or appropriate.

The current affiliate transactions rules satisfy the nondiscrimination requirements of §274(d) for network access and interconnection for basic telephone service that the BOC provides to the separated affiliates or joint venture. Those rates will be tariffed (so long as rates for such services are subject to regulation) according to the terms of §274(d). For that reason, the current affiliate transactions rules that require that tariffed services be provided at tariffed rates applies. No further regulation is required. *NPRM*, para. 117.

IV. Price Caps Regulation Eliminates The Need For Accounting Safeguards

The Commission appropriately recognizes that price cap regulation significantly changes the need for existing Part 64 cost allocation rules. *NPRM*, paras. 120-121. Price caps regulation limits the prices that LECs may charge for their regulated services. In that regard, the Commission inquires about the implications of two aspects of price cap regulation on the accounting safeguards rules: exogenous costs and sharing.

A. Reallocations As A Result Of The Commission's Implementation Of Accounting Safeguards Pursuant To The 1996 Act Should Not Trigger An Exogenous Adjustment To Reduce Price Cap Indices

Exogenous cost treatment permits an adjustment to price cap indices for costs beyond the carrier's control, not otherwise accounted for in the price cap formula. *NPRM*, para. 122. Adjustment for exogenous costs is permitted only for specified cost changes.[41] The Commission seeks comment on whether cost reallocations from regulated to nonregulated activities due to changes in the Part 64 cost allocation process would be treated exogenously pursuant to §61.45(d) and trigger reductions in price cap indices. *NPRM*, para. 123. The Commission's question is specifically directed to any reallocation to nonregulated activities that may result from the provision of telemessaging service. *NPRM*, para. 123.

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[41] 47 U.S.C. §61.45(d).

We do not agree that a strict reading of the price cap rules would require exogenous cost changes as a result of the reclassification of costs due to changes in the Part 64 cost allocation process. Section 61.45(d)(1)(v) provides for exogenous treatment of "the reallocation of investment from regulated to nonregulated activities pursuant to §64.901." Section 64.901 describes how a carrier must allocate costs. The Commission's suggestion that exogenous cost treatment is applicable to all changes in the Part 64 cost allocation process far exceeds the plain meaning of its own regulation. The language of §61.45(d)(1)(v) is clear. Exogenous treatment applies to the reallocation of investment pursuant to Part 64 but a change in the Part 64 cost allocation process is not a reallocation.

The term "reallocation" is clearly inapplicable when applied to the specific question of the *NPRM* regarding telemessaging services. First, the Commission's present Part 64 rules "classify telemessaging service as a nonregulated activity for Title II accounting purposes." *NPRM*, para. 30. Facilities used by an integrated telemessaging service would be currently allocated as nonregulated, and none of those costs would need to be "reallocated."

Second, conceptually, "reallocation" in the Part 64 vernacular is used to describe a change in investment classification due to an underforecast of nonregulated costs.[42] The Commission established the reallocation rule during a time when every carrier's regulated costs would affect its rates. In that situation, underforecasts of nonregulated services reduce costs allocated to the nonregulated activity and increase costs to regulated activities. The reallocation rule discourages underforecasting and requires a carrier to pay interest on the underforecasted

[42] *Joint Cost Reconsideration Order*, para. 33, n.32.

amount as a means to redress the misallocation. Exogenous treatment of a "reallocation" due to underforecasts of nonregulated usage is consistent with public policy goals.

Even if properly limited to underforecasts, however, the reallocation rule has limited applicability for price cap carriers. An exogenous adjustment would be appropriate only for an underforecast of nonregulated use for the period July, 1990 to July, 1991 which could have resulted in inflated initial price cap indices. Initial price cap rates were calculated and capped based on facilities in place during July 1990 - June 1991. Underforecasts of nonregulated investment use for subsequent periods would not affect rates and, exogenous treatment should not apply.

The *NPRM*, however, incorrectly suggests that a change in the status of facilities from regulated to nonregulated for other than underforecasting is a "reallocation" for which exogenous treatment is appropriate. (Notably, the Commission does not suggest that BOCs should also be subject to interest on the investment which the reallocation rules require.) The changed status of regulated services (such as interLATA telecommunications services) to nonregulated for Title II accounting purposes only occurs in order to accommodate the application of Part 64 rules. That should not be deemed to be an "reallocation" to trigger exogenous treatment.

The Commission also asks about exogenous adjustment of new investment in network plant. The Commission specifically references network plant which might later be used for telemessaging service. First, the Commission's characterization of the change in usage as a "reallocation " is not correct. *NPRM*, para. 123. The cost allocation rules specifically permit a carrier to forecast increasing use of joint and common investment for nonregulated activities. In other words, Part 64 rules intend that there be adjustments in the nonregulated usage of plant.

Forecasts of plant usage are undertaken each year in order to adjust for the changes in the regulated and nonregulated use of joint or common plant. That is not a "reallocation." Second, the initial price cap rates were based on cost forecasts for the period July, 1990 - June, 1991. The Commission has not permitted BOCs to include infrastructure improvements since then in price cap rates. Thus, investment in network plant since June, 1991 ("new investment") has not and will not be included in price caps rates, and adjusting the price cap indices for a change in the status of new investment would be improper. New investment has never been part of the price cap equation; it has been funded by shareholders, not ratepayers. Investment that was never included in price cap rates should not be "taken out" since that would result in an inappropriate transfer of shareholder value to ratepayers. Thus, if the Commission chooses to treat cost of reclassified investment as exogenous, that requirement must not apply to new investment.

Requiring exogenous treatment for the reclassification of embedded investment is also inconsistent with the Commission's previous determination that: "Progress toward market-based rates and away from rate of return regulation will be impeded, however, if we continue indefinitely to allow exogenous cost adjustments that have the purpose and effect of perpetuating the relationship between accounting costs and rates that existed on July 1, 1990."[43]

Nor should the Commission view exogenous treatment of embedded facilities as a way for ratepayers to share in the economies of scope. *NPRM*, paras. 7, 9, 70. Exogenous treatment is not necessary to capture economies of scope for integrated operations because the Total Factor Productivity (TFP) methodology (with annual updates through a moving average)

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[43] *Price Cap Performance Review for Local Exchange Carriers,* 10 FCC Rcd 8961 (1995) ("*Interim LEC Price Cap Order*"), para. 299.

that the Commission has tentatively adopted in the *Interim LEC Price Cap Order*[44] will automatically pass on all economies of scope to telephone ratepayers. Ratepayers have the benefit of the economies of scope because under Part 32 rules, nonregulated services that have joint and common inputs with regulated services are included in operating revenue and operating expenses. The TFP includes these revenues and expenses. Therefore, all joint and common cost savings realized by an integrated network are in the TFP value. The TFP will be included in the productivity factor that the Commission requires price cap LECs to annually apply to their price cap indices (PCIs). All economies of scope will therefore be passed through to telephone ratepayers through reductions in the PCIs. No other adjustments are appropriate and, in fact, exogenous treatment of reclassified embedded facilities would be a double reduction. In any event, the TFP value that will be used to reduce the PCIs provides benefits to the ratepayers on all vintages of investment, and passes on the economies of scope associated with a network that is used for both regulated and nonregulated services.

For separated operations, economies of scope will be captured to the extent the BOC is permitted to provide services to its affiliates. Affiliate transactions payments are treated as revenue, and also included in the TFP calculation.

As a practical matter, implementing exogenous treatment for changed usage will be difficult for BOCs to accomplish. In order to properly treat investment exogenously, BOCs would have to determine the vintage of the investment being reclassified to determine if the investment was included in the initial price cap rates. This task would be extremely burdensome, if possible at all. For example, Pacific Bell does not track poles by vintage.

[44] *Interim LEC Price Cap Order*, para. 11.

In summary, the Commission should not interpret the requirements of §61.45(d) to routinely require exogenous treatment of investment reclassified from regulated to nonregulated use except where an underforecast of usage resulted in the inflation of the initial price cap indices.

B. *The Commission Should Forebear From Applying Part 64 To Price Cap Carriers That Elect The No Sharing Option*

As the Commission recognizes, segregating regulated and nonregulated costs is largely irrelevant and unnecessary for carriers under price cap regulation. Part 64 rules are of no benefit to ratepayers when a price cap carrier elects a no sharing option. As the Commission states, "under pure price cap regulation, there would be few incentives to subsidize nonregulated services with revenues from regulated telecommunications...." *NPRM,* para. 121. Given that relationship, the reality of competition, and the 1996 Act's directive that the Commission forbear from unnecessary regulation, the Commission should forbear from applying the Part 64 rules to the activities undertaken by BOCs pursuant to the 1996 Act .

Under price cap regulation, LECs' rates are not tied directly to cost allocations.[45] Rather, prices of services (within specific baskets) are capped, and subsequently influenced only by changes in general inflation, productivity and exogenous costs. Thus, the link between cost and regulated prices is severed, thereby reducing the incentive and possibility for BOCs to shift nonregulated costs to regulated services. As the D.C. Circuit explained, under price caps there is no "reward for shifting costs from unregulated activities into regulated ones, for the higher costs

[45] *BOC Safeguards Order,* para. 55.

will not produce higher legal ceiling prices."[46] Any incentive is limited to that vestige of rate of return regulation known as the "sharing mechanism." Without the sharing mechanism, there is no link at all between cost allocations and regulated rates, and no possibility that regulated services will subsidize nonregulated services. Consequently, cost allocation requirements as safeguards are irrelevant for price cap LECs that have elected the no sharing option.

Currently, each LEC can annually elect a sharing or no sharing price cap regulation plan.[47] In the past annual filing, Pacific Bell (and all but one price cap LEC) chose the no sharing option.[48] For these no sharing price cap LECs, calculations of regulated and nonregulated costs are of no consequence to their regulated rates. Simply stated, their costs do not affect their rates. Concerns about cross subsidy are clearly misplaced when costs cannot affect regulated rates. Competitors' suggestions that the BOCs be required to comply with burdensome and costly regulatory processes to protect ratepayers from "cross subsidies" are false claims, and merely attempts to obtain an unfair competitive advantage. The 1996 Act intends

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[46] *National Rural Telecom Ass'n v. FCC*, 988 F.2d at 178; *see United States v. Western Electric Co.*, 993 F.2d 1572 (D.C. Cir. 1993), at 1580 (shift to price caps "reduces any BOC's ability to shift costs from unregulated to regulated activities"). The Commission too agrees with this conclusion. *See Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd 2873 (1989), at 2924, para. 104 (price-cap regulation "substantially curtails the economic incentive to engage in cross subsidization"); FCC Tel. Price Caps: Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 101st Cong., 2d Sess. at 12 (1990) (Statement of former FCC Chairman Alfred Sikes) (price cap regulations leave regulated firms with "virtually no ability to pass along cost increases that are within their control" and drastically reduce the concerns about cost-shifting); *BOC Safeguards Order*, para. 55 (price cap "severs the direct link between regulated costs and prices" thereby "reduce[ing] the incentive for the BOCs to shift nonregulated costs to regulated services").

[47] *Interim LEC Price Cap Order*, para. 184.

[48] Those LECs assume more risk (through the significantly higher 5.3% X-Factor) in exchange for the potential to realize greater earnings.

that all parties, including BOCs, have fair opportunities to compete. The Commission must adopt rules that foster the purpose of the 1996 Act.

Part 64 should be entirely eliminated when there is effective competition for LEC services. As the Commission has frequently asserted, government intervention should give way to market forces where effective competition tempers costs, and prices. Pacific Bell no longer has a monopoly on any service. In California, competition exists for interLATA long distance service and for local exchange service. The California Public Utilities Commission has certified more than 30 facilities-based providers and more than 60 resale providers to provide local service.[49] With the BOCs entry, the long distance services market will be more competitive. With competition, regulations established to protect ratepayers, such as Part 64 cost allocation rules, are unnecessary. The Commission should act now, as it asserts, to eliminate these unnecessary rules. *NPRM,* para. 8.

In addition to being irrelevant as safeguards for price cap carriers, the Part 64 requirements impose substantial administrative and financial burdens on LECs (for example, filing and maintaining cost allocation manuals, implementing and maintaining complex cost accounting systems and studies to carry out the procedures described in the CAM, training personnel on time and cost reporting procedures, preparing reports related to Part 64 accounting, and paying substantial audit fees). These numerous and costly requirements can inhibit LEC entry and full participation in competitive services because competitors do not have these substantial burdens. Moreover, complying with regulation ultimately raises the price of

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[49] *Competition for Local Exchange Service,* CPUC Decision No. 95-12-056, slip op. (December 20, 1995); CPUC Decision No. 96-02-072, slip op. (February 23, 1996).